Crèdit Andorrà Financial Group

Fourth quarter 2015
Date of Report: 30th September 2015

Quarterly Report

Our View on the Markets

INDEX

Superheroes vs. Volatility

Volatility of all financial assets is rising, a trend which we don't think – by a long shot – is temporary. In fact, we believe it's here to stay as central banks either aim to withdraw stimuli (the jury is still out on this move) or continue to implement them but no longer convincingly vis-à-vis their effectiveness.

For a long time we have enjoyed the anaesthesia injected by **central banks** (CBs). Whenever there's been a lack of growth, the outbreak of a political crisis, worries regarding excess debt, fragility of the financial system, or the appearance of any other setback that might pose a challenge to markets, sooner or later a CB has shown up to save the day by cutting interest rates (706 times! since the beginning of the crisis!!) or expanding balance sheets. Superman, Batman and other superheroes are laughable. Quantitative Easing. That is truly a great superpower.

Unfortunately, it looks like the concurrence of several factors have been unravelling the haven of peace. Currencies, fixed income, equities, commodities… **Nothing has escaped from volatility** that has been skyrocketing in increasingly frequent and more virulent bouts. This situation can probably be traced back a bit more than two years to when Bernanke added "tapering" to the financial glossary, underpinned by the fact that the Fed was veering the course of its monetary policy. The supply of liquidity by our planet's top CB (60% of global trading is still carried out in US Dollars, the predominant currency used for reserves and in which commodities are denominated) is no longer expanding. Fixed income initially suffered sharp declines but soon Japan and the previously ultraorthodox ECB joined the expansionary monetary policy bandwagon and, thereby, mitigated this situation. Yet, the bases of greater fixed income instability were already in place. Increasing volumes of debt issues – beating record after record – have been accompanied by ever more restrictive positioning of banks, whose own books have been greatly penalised by the new regulatory framework. Treasury desks played the role of buffers during times of upheaval (they were the only buyers appearing in times of panic).

We would also highlight the popularisation of ETFs which give the appearance of a liquid asset which isstill traded by phone: deal by deal. However, the day that sellers come banging on the door we would expect a whole different ball game. Moreover, 0% rates have moved to much riskier tranches of assets than usual. Clearly, this is a cocktail which may lead to a great hangover.

With the **Chinese slowdown** dragging down with it both emerging markets – many with currencies suffering spectacular cumulative drops this year – and commodities (a similar story), it was only a question of time before equities ended up correcting as well. The latter is also suffering more than a few structural problems. One example is 24 August 2015: Stock markets nosedived that day and the S&P 500 came close to suffering a shutdown for surpassing the volatility limit. Massive sales were not underpinned by any fundamental rationale. Possible catalysts were programmed trading, ETFs replicating indices by selling stocks – thereby triggering further downtrends – and the loss of relevant technical supports. Yet, whatever the triggers, we have no reason to believe that this situation cannot be repeated.

Perhaps, **neither Superman exists nor is Quantitative Easing a superpower**. CBs don't have a secret potion for curing volatility. Too much anaesthesia may have left the patient overly accustomed to the medicine. The only truly effective remedy is growth, which remains elusive. The Chinese say that risk is opportunity. We plan to maintain sufficient liquidity and attempt to make good use of it.

David Macià, CFA
Chief Investment Officer

Strategy

Asset Allocation (2015 Q4)

Monetary	⬆
Government Fixed Income	⬇
Corporate Fixed Income	⬇
Equities	⬆

Fixed Income

GOVERNMENT:	
US	⬇
Eurozone	⬇
CORPORATE:	
US	⬇
Eurozone ("Core")	⬇
Periphery	⬇

Equities

US	➡
Eurozone	⬆
Japan	⬆
Emerging Markets	➡

Commodities

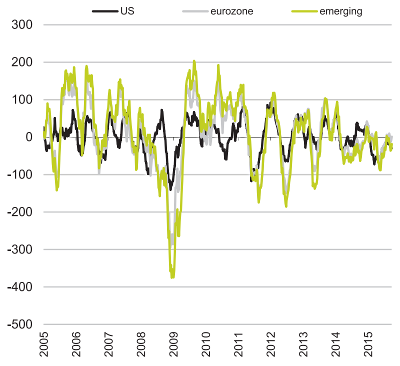
Oil	➡
Gold	➡

Currencies

EUR/USD	➡

Macroeconomic View

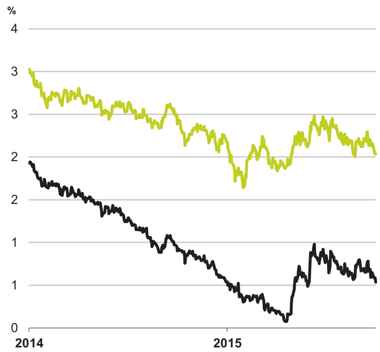
Economic surprise indicator (Citi)



Source: Bloomberg

In the last year we have witnessed a period in which economic surprises have not been particularly different to previous years, in any case they have slightly lower.

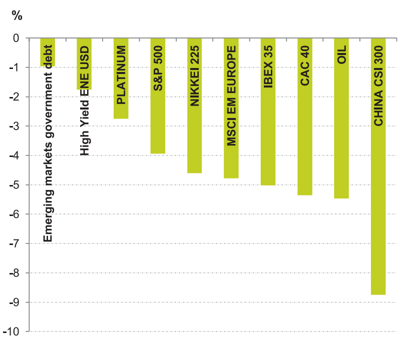
Main fixed income bonds (YTM)



Source: Bloomberg

The upturn in mid-year rates was surprising and generated significant losses in the fixed income universe.

Financial markets movements on August 24th



Source: Bloomberg

Movements in risky assets were extreme on 24 August.

The ingredients of volatility

During the past few quarters the volatility of financial markets has increased and the trend towards greater correlation of assets continued. What are the causes of this rise in volatility? We detail and analyse the factors which we consider most relevant in this section.

Why has volatility increased recently? A typical suspect tends to be economic surprises: i.e. unexpected inflation or growth data which, for example, drives up the stock market. However, academic research suggests that daily movements of financial asset prices are not due merely to changes in economic fundamentals. A recent BoE study indicates that, depending on the timing, economic surprises can explain 0-40% of fluctuations in interest rates with the normal level amounting to less than 10%. Moreover, it doesn't look like in recent quarters we have observed a period of particularly surprising economic data for analysts, but rather the opposite seems to be true (refer to Graph 1). In our view, other factors are more relevant for explaining the recent uptrend in volatility, which we detail as follows:

economic surprises can explain 0-40% of fluctuations in interest rates

A) The **market structure** may have contributed to the recent rebound of volatility. Over the past few years, intermediation of bonds by banks has been limited, reducing their capacity to react in times of stress. Furthermore, the volume of products promising immediate reimbursements of portfolios with highly illiquid assets have increased, emitting a false liquidity signal which aggravates the situation at times of panic. Finally, trading carried out using computational algorithms has increased (already accounting for over 50% of total transactions according to the IMF). These factors were partially responsible for events which took place on 15 October 2014 (*Treasury Flash Crash*) when the most important financial asset in the world, the US 10-year bond, became illiquid and its price skyrocketed in just minutes by nearly +3%. This was clearly an extraordinary event as daily fluctuations in the price of this asset of over ±1% are already considered to be abnormal.

B) In recent quarters several **central banks** (CBs) have announced extraordinary measures. One example is the Swiss CB (SNB): on 15 January 2015 it eliminated the target of maintaining a maximum exchange rate vs. the Euro. Following this decision, the Swiss Franc appreciated immediately by +41% vs. the Euro, although by the end of the day its uptrend had slowed to +21%.

C) In addition, the current scenario of **historically low interest rates** implies that we may be surprised by a rebound. We have already witnessed some very violent swings in the 10-year German bond which jumped from historically low rates on 20 April 2015 of 0.05% to 1% in barely two months; historically high levels of volatility were registered on 7 May (21bp of intraday swings) as well as on 2 and 3 June (20bp).

D) Finally, **panic** regarding the possibility of **China** no longer playing the role of global economic driver is worrisome, very much so, for financial markets. This was evident on 24 August 2015 when a poor figure (among many others: i.e. this was nothing new) triggered panic among investors. Global stock markets declined by nearly -10%, although finally ending up the day with downtrends of -4/6%. During this event, we saw how nearly 20% of ETFs in the US had to halt trading at some point during the day due to extreme levels of volatility suffered.

Looking forward, with the Fed about to raise interest rates, China slowing down, rates still at historically low levels and with previously-commented weaknesses in the current market structure, we believe that we are likely to continue to have all the ingredients necessary for underpinning on-going volatility.

Pablo Manzano
Macroeconomic Analyst

Fixed Income

Fixed income: Less fixed than ever

Difficulties of traditional fixed income investors will not be caused by a substantial uptrend in the number of bankruptcies of issuers. In our opinion, an increase in the volatility of bond prices is likely to underpin the penalisation of returns on their portfolios prior to maturity.

"The long and winding road", the title of a famous Beatles song is a good simile for describing our medium-term view on the lives of traditional fixed income investors. Volatility experienced by the interest rates market in recent months is not, in our view, an isolated event but rather is here to stay.

The main cause of expected volatility over the medium term is the **drastic decline in the liquidity of fixed income markets**. Some figures illustrate this situation: the most liquid market in the world – 10-year US public debt – has dropped from the level of USD500Mn in 2007 to USD125Mn presently; meanwhile, the corporate fixed income market has risen by +50% since 2007 but the positions of intermediaries have declined by -75%.

Volatility suffered in recent months is not an isolated event but rather it is here to stay.

The reason underpinning this lack of liquidity is the **new regulatory framework of financial institutions** arising following the crisis that – whilst aiming to improve the sector's capitalisation and level of security – **has considerably dampened traditional activities of intermediaries in the markets**.

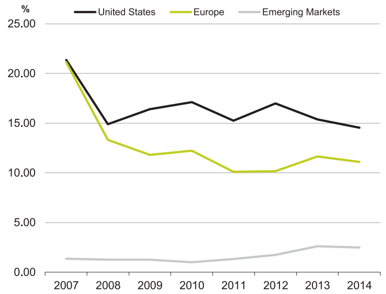
On 15 October 2014, 10-year US interest rates fluctuated by 40bp in just one day. According to normal behaviour, this should happen once every 3 billion years. Although perhaps not to this extent, we believe that - under the current scenario - an adequate breeding ground for situations entailing swings in prices not normally seen on a regular basis in the past is being created. Thus, looking ahead, we foresee the possibility of more frequent such movements taking place.

Extremely expansionary monetary policies of the majority of central banks have anesthetised the markets, giving investors a false sense of stability. Sooner rather than later, the main monetary policies should begin to normalise with official interest rates lifted and liquidity injections by monetary authorities pared down. Investors will wake up and we fear that this wake-up-call won't be exactly placid.

Therefore, we wouldn't let down our guard since some investors certainly are not lion-hearted enough to bear expected levels of volatility. We are expecting sharp curves ahead and that we will need to keep our seat belts firmly fastened. Clearly and without a doubt, we would take advantage of any corrections to buy bonds of unfairly punished issuers. Yet, we would calibrate risk profiles precisely and wouldn't underestimate potential overreactions of fixed income markets.

Meritxell Pons Torres, CAIA
Director of Asset Management Americas

Securities held by major banks, % of total earning assets



Source: BIS

The new financial regulation limits inventories of fixed income assets of large banks.

Official Rates:
Consensus Forecasts (%)

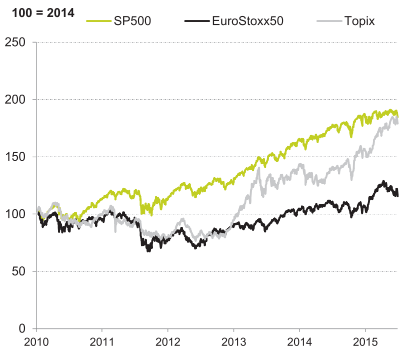
	30/09/15	4th Q '15	1st Q '16	2nd Q '16
Eurozone	0.05	0.05	0.05	0.05
US	0.25	0.55	0.85	1.05
United Kingdom	0.50	0.50	0.70	0.85

Interest Rates: Changes (%)

	30/09/15	Last 3 months	Last year
Eurozone			
3-month Euríbor	0.04	-0.03	-0.12
10-year Bund	0.59	-0.26	0.05
UA			
3-month US Libor	0.33	0.04	0.07
10-year US	2.04	-0.35	-0.13
United Kingdom			
3-month GBP Libor	0.58	0.01	0.02
10-year Gilt	1.76	-0.32	0.01

Equities

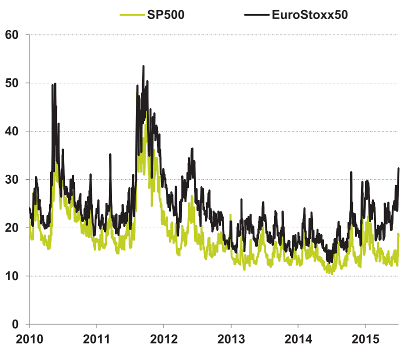
Developed equity markets



Source: Bloomberg

The last quarter was negative for global stock markets.

Implied volatility



Source: Bloomberg

The volatility in global stock markets has risen in the last year.

			Q3 %	2015 %
US	S&P 500	1,920	-6.94%	-6.74%
	DJ Indus. Avg	16,285	-7.58%	-8.63%
	NASDAQ 100	4,181	-4.91%	-1.30%
EUROPE	DJ Euro STOXX 50€	3,101	-9.45%	-1.45%
	France (CAC 40)	4,455	-6.99%	4.27%
	Spain (Ibex 35)	9,560	-11.23%	-7.00%
	UK (FTSE 100)	6,062	-7.04%	-7.68%
	Germany (DAX)	9,660	-11.74%	-1.48%
	Switzerland (SWISS)	8,513	-3.05%	-5.23%
	Italy (FTSE MIB 30)	21,295	-5.19%	12.01%
	Netherlands (AEX)	421	-10.88%	-0.78%
JAPAN	TOPIX	1,411	-13.45%	0.26%
	NIKKEI 225	17,388	-14.07%	-0.36%
EMERGING MARKETS	Mexico	42,633	-5.37%	-1.19%
	Brazil	45,059	-15.11%	-9.89%
	Argentina	9,815	-15.80%	14.40%
	China	3,053	-28.63%	-5.62%
	India	26,155	-5.85%	-4.89%
	Korea	1,963	-5.37%	2.47%
	Russia	1,643	-0.70%	17.64%

Fasten your seat belts for turbulence

Current macroeconomic data combined with a fragile equities market are likely to create more volatility and higher risk of correction. Therefore, investors should adjust their exposure to equities depending on their investment time horizons and profiles.

Volatility in the equity market is typically measured by the **VIX Index** which is also called the "fear index" as it highlights the current level of investors' confusion about that market. After the FED's recent (September 2015) decision to maintain interest rate levels, uncertainties on the market environment are high and are likely to prevail. The FED decided to buy time to better understand the impact of slowing growth in China on the US economy. The only problem with this strategy is that the market hates uncertainties and **we are likely to see more volatility** as a result. The equity market began to experience turbulence with the correction of -15% registered during the week of August 24th. Equity volatility is auto correlated: when volatility is high it stays high for a while. Using an analogy, a volatile equity market is like an airplane experiencing turbulence: turbulence stays for a while and so does the volatility of an equity market.

Current equities characteristics will also contribute to greater volatility. US valuations are not cheap right now with a forward PE of 16.5 and flat earnings growth this year. Furthermore, we don't foresee any improvement of US companies' gross margins which are already historically high. This combination of factors leads us to believe that the risk of **higher drawdowns** has increased. This risk should be worrisome for investors as it may potentially drive them to make irrational decisions. An investor can only bear a certain level of losses before he begins to make decisions that will damage his wealth: the most common case is when an investor opts to sell at the bottom of the market. Each investor should be aware of his/her **aversion to loss level** in order to determine an optimal allocation to equities.

Some asset managers understand the importance of volatility for portfolio construction. This is why we have seen an increase in approaches such as risk parity where the exposure to an asset class depends on its volatility; thus, a portfolio's exposure to equities decreases when the volatility of this asset class increases. Other asset managers consider using volatility as an asset class on its own and recommend maintaining exposure to volatility at all times. Typically, as the equities market declines, volatility rises and being long volatility is a good way to diversify.

Volatility isn't necessarily a bad thing for investors as it creates a lot more opportunities for active traders to make some profits by getting in and out of positions. As volatility rises, dispersion of returns amongst stocks also increases and more attention should be paid to stock picking and fundamental research. After a 6-year bull market and extremely low volatility, we expect higher volatility going forward. All investors should understand the implication of volatility and its impact on exposure to equities. **Time horizon** remains the most important factor for portfolio construction; for example, the probability of having negative returns on equities in one year is 27% and it drops to 11% after 5 years. Over the long term equities remain the most attractive asset class. Yet, in turbulent times, investors should **adjust their exposure to this asset class** in accordance with their profiles and time horizons.

Stephane Prigent, CFA
Analyst Latam

Commodities and Currencies

COMMODITIES

An extreme relationship

Since June 2014 commodities prices have dropped sharply, particularly in the cases of oil (-60%), iron ore (-25%) and copper (-25%). Since then we can identify three periods; 1) strong declines until December 2014; 2) stabilisation until April 2015; and 3) a new round of downtrends henceforth. Moreover, in the third stage we have detected that the relationship between the prices of some assets linked to commodities and the latter is **extreme**. We think this reflects the high level of uncertainty regarding future prices of most raw materials (at very high levels according to volatility implicit in oil price options) as well as high financial gearing of oil companies, which has risen over the past few years and concerns investors.

This extreme relationship was apparent in **equities** markets last September. The stock price of mining company Glencore nosedived by nearly -30% in just one day after an analyst published a negative note. This report affirms that if weak prices continue, in his view, the group's valuation would be practically nil.

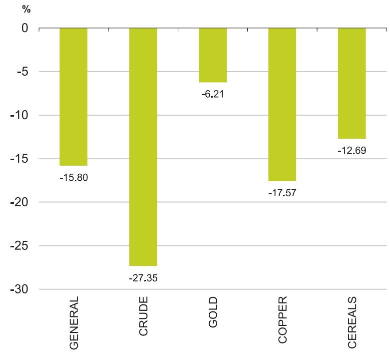
The company, which is highly exposed to the copper market, registered this one day drop in spite of the fact that copper prices only declined by -1.40%. Over the next few days, the stock price rebounded sharply, ending up surpassing its initial price.

In the **fixed income** arena, securities related to commodities are also apparently suffering more than underlying assets. This is particularly the case of USD-denominated high yield assets (i.e. debt of companies with low credit quality) issued by oil companies. While in the first stage oil prices shed -40% and the Bloomberg high yield energy index fell -15%, in the third stage we have witnessed a -25% downtrend in oil prices whilst high yield assets have fallen -17%.

Given this situation in which the **relationship** between raw materials and certain assets has become **extreme**, we would take a prudent stance and rely on the advice of experts in order to take advantage of any opportunities which may arise.

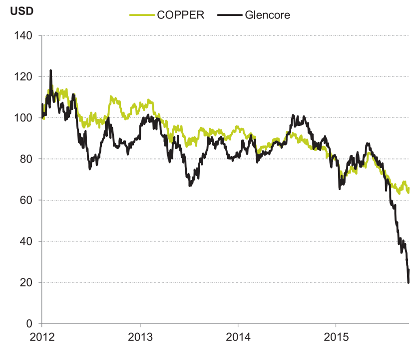
Pablo Manzano
Macroeconomic Analyst

YTD performance of DJ UBS TR commodities



Source: Bloomberg

Copper



Source: Bloomberg

CURRENCIES

Awaiting central bank moves

During the last few quarters, as we comment in the section *called ingredients of volatility*, measures implemented by **central banks** (CBs) have been key catalysts of volatility, especially in currency markets. Thus, we have witnessed explicit changes in foreign exchange targets of two of the main CBs in the world, SNB (Switzerland) and PBoC (China), which pretty much triggered turbulences throughout the entire currencies universe.

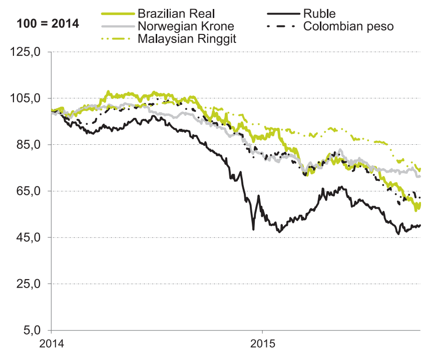
In foreign exchange markets, we have also witnessed how those countries with economies strongly linked to **commodities** registered a level of volatility during the past 6 months which was significantly greater than during the prior 5 years. In this group we would highlight the currencies of Colombia, Malaysia and Norway, which suffered increases in volatility of +70%, +40% and +20%, respectively. The cases of Russia and Brazil deserve a special mention since, in addition to their links with commodities, these countries are suffering major domestic economic weaknesses. The increase in volatility of currencies of both countries – which are top-10 global economies – amounted to +50%.

For the upcoming months, consensus forecasts expect official rate hikes by **CBs** of the US and, later on, the UK. Meanwhile, analysts wouldn't rule out the possibility that CBs of China, the Eurozone and Japan might implement new expansionary measures. This looks like a breeding ground for investors to take speculative positions in anticipation of such moves (*shock 1*) with high probabilities that expectations are not fully met, thereby burning investors' fingers (*shock 2*). In addition, we continue to think that **commodities** markets will continue to face downwards pressures, thus affecting volatility of currencies of economies linked to those assets.

Under this scenario, we believe that the volatility of currencies will continue the uptrend observed in recent years. Moreover, we think that currencies of emerging countries are the worst-positioned given expectations of on-going – and most certainly frequent – times of high uncertainty ahead.

Pablo Manzano
Macroeconomic Analyst

Currencies linked to commodities



Source: Bloomberg

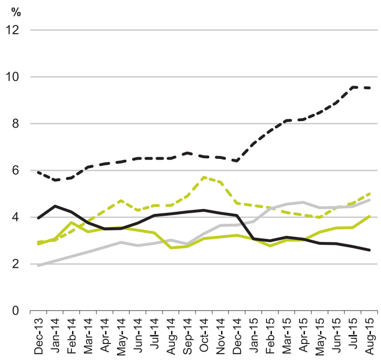
The weakness of commodities has pushed down certain currencies, and increased their volatility.

Exchange rate $/€

% change:	1 month	3 months	1 year
	-1.22%	0.84%	-11.51%
Consensus forecast:	4th Q '15	2015	2016
	1.08	1.08	1.05

Latin America

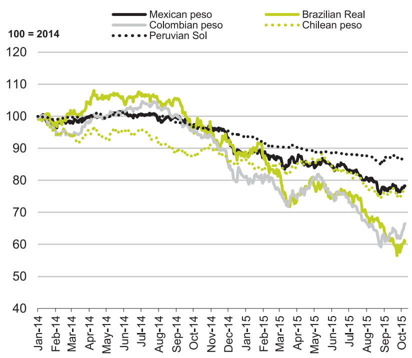
Inflation



Source: Bloomberg

Countries will have to counteract the effect of "pass through" inflation due to the depreciation of currencies.

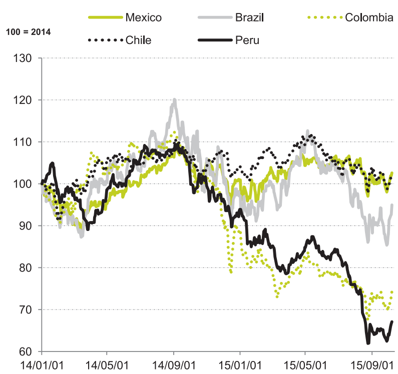
Currencies



Source: Bloomberg

Latin American currencies have depreciated to the lowest levels in 12 years.

Equities



Source: Bloomberg

Equity markets are exposed to real and financial contagion.

Volatility: The Dark Side of globalisation

Devaluations and monetary volatility will continue to impact the credit quality of Latin American governments, companies and banks. In record time markets jumped from complacency to panic.

Depreciation of currencies, which began in mid-2014, is not expected to reverse over the short term. Moreover, some currencies may weaken even further. Complicating matters further, Latam financial markets appear to be increasingly responsive to global factors rather than specific factors: i.e. volatility doesn't discriminate. An extended period of monetary volatility and devaluation comprises a negative credit risk factor for Latam sovereign and corporate issuers which must confront the need to refinance US Dollar denominated debt. Prices of the main commodities suffered the impact of volatility of financial markets in China, but mainly reacted to supply-side shocks.

South America is much more exposed to the **volatility of prices of basic products** than Mexico and Central America. The news is that in Latam there are several countries capable of dealing with these "dark sides" of financial globalisation whilst others are not. Some have implemented consistent anti-cyclical policies but which will affect growth.

> We hope that volatility, noise, uncertainty and panic don't prevent us from seeing the forest, but not all trees are equal.

Chile is the most telling example, but this is also the case of Peru and Colombia. However, Argentina, Venezuela, Ecuador and to some extent Brazil implemented doubtful measures which have put investors' confidence at risk. Volatility of prices of exportable products can prove to be very costly if responsible management is lacking. **Floating exchange rates**, independence of central banks, the level of international reserves and access to local capital markets are factors which should alleviate tension. Governments may capitalise on deepening of savings and local investment schemes which may reduce their dependency on debt denominated in foreign currencies.

Local pension funds have grown and may turn into suppliers of liquidity and investment funds over the medium to long term. In Chile funds amount to 70% of the GDP and in countries such as Peru, Colombia and Mexico they are getting close to the level of 15%.

In the region, higher interest rates over the next 6/12 months should affect growth levels. Latam is currently facing a combination of sharp negative external shocks. Money market pressures are likely to continue and the need to maintain **inflation targets** could soon spur the need to tighten monetary conditions in the region even though this would imply a downtrend in employment; this is what is happening in Brazil and, recently, also in Peru and Colombia. This appears to be occurring throughout the region, which is quite different from the scenario faced during the 2008 global financial crisis when central banks cut interest rates. Increases in international and local interest rates are expected to be a headwind for economies. Those countries that have used up their margin for fiscal manoeuvring must carry out very sharp adjustments in order to recover credibility: e.g. Brazil, Argentina, Ecuador and Venezuela. We expect to see a **very sharp contraction of aggregate demand**. Yet, we don't see risk of an overall crisis since many countries are still enjoying greater macroeconomic strength and higher reserves than in the past and have more tools on hand. For example, markets have developed derivative instruments which can soften the effects of devaluations and interest rate hikes and future markets can also be used: e.g. by Mexico to fix **oil prices**. Central banks are using derivatives to try to rein in volatility without aggressively selling US Dollars in order to ensure greater market stability whilst avoiding the interventions of the past.

Raúl Ponte
Head of LATAM Fixed Income

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